



# FORESTRY EXTENSION NOTES

## HOW CURRENT TAX LAWS AFFECT WOODLAND OWNERS

### TAX RATES

Taxable income is calculated as adjusted gross income less personal exemptions and the standard or itemized deductions.

In 1997, a five-bracket rate schedule is in effect for individual taxpayers: 15%, 28%, 31%, 36%, and 39.6%. Taxable Income Brackets for 1997 are:

Tax Rate	Married Filing Joint Return	Heads of Households	Singles
15	0-41,200	0-33,050	0-24,650
28	41,200-99,600	33,050-85,350	24,650-59,750
31	99,600-151,750	85,350-138,200	59,750-124,650
36	151,750-271,050	138,200-271,050	124,650-271,050
39.6	Above 271,050	Above 271,050	Above 271,050

All brackets are adjusted annually for inflation.

It is important to consider your marginal tax rate before making a timber sale. Making smaller sales or delaying the sale a year will help some people avoid a higher tax rate on timber gains.

### PERSONAL EXEMPTIONS

Personal exemption for each individual, individual's spouse, and for each dependent is \$2,650 for 1997. The personal exemption is adjusted annually for inflation.

The personal exemption amounts are phased out for taxpayers with higher taxable incomes. Depending on your filing status, your personal exemptions will phase out at taxable incomes between \$90,900 and \$181,800, in 1997. The taxable incomes at which the personal exemption phases out is adjusted annually for inflation.

### CAPITAL GAINS

In 1997, changes were made to both the capital gains holding period and the tax rates. If you are in the 15% tax bracket, your capital gains rate is 10%, and if you are in the 28% or higher tax brackets, your capital gains rate is 20%. After July 28, 1998, the length of time that property must be held to qualify for capital gains is 18 months.

If you are in the 15% tax bracket, there is now a special long-term capital gains rate of 8% for assets that you acquire before January 1, 2001 and hold for more than five years. If you are in the 28% or higher tax brackets, you qualify for a special capital gains rate of 18% if you acquire the asset after December 31, 2000.

The calculation of gains or losses, basis of timber sold, and depletion allowance for timber cut stay the same. Since, profit from the sale of logs, lumber, or other products does not qualify as capital gains, capital gains treatment may be in question if you agree to a "shares contract" with a logger. Short-term and long-term gains and losses are netted against each other as before. Also, capital gains are not subject to self-employment taxes.

### INCOME AVERAGING FOR FARMERS

Three-year income averaging was reinstated for farmers. Farmers are defined as those subject to the

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uniform capitalization rules. Timber growers are not required to follow the uniform capitalization rules and thus do not qualify for income averaging. Some timberland owners are also farmers as defined by the Internal Revenue Code, and those landowners may qualify for income averaging with timber income treated as incidental farm income.

## **COST RECOVERY**

Costs that are deductible and costs that must be capitalized to your land or timber account stay the same. In 1988, the at-risk rules were tightened, a class of "passive" activities subject to restrictions was established, and additional limits were placed on the deductibility of nonbusiness interest.

## **LIMITATIONS ON LOSSES AND CREDITS FROM PASSIVE ACTIVITIES**

For application of the passive loss rules, income (losses) will fall into three categories:

1. Active — — salary; bonuses; and profits (losses) from business, trade, or other for-profit activities in which the taxpayer "materially participates".
2. Portfolio — interest; dividends; royalties (unless earned in the ordinary course of a trade or business); gain or loss on the sale of property generating portfolio income or held for investment; and other sources.
3. Passive — — income (losses) from limited partnerships; other business, trade, or investment activities in which the taxpayer does not materially participate; and rental activities whether or not the taxpayer materially participates.

The meaning of "passive activity" is of crucial importance to the application of the limitations on offsetting deductions and credits against other income. Losses from passive activities can offset only passive income and cannot be used to offset active or portfolio income. Likewise, credits from passive activities are limited to the tax attributable to the passive activities. Unused losses and credits from passive activities can be carried forward and applied as deductions and credits against passive income in future years. Basis in property is reduced by depreciation, amortization, etc., even if the deductions are not usable currently because of the passive loss rules. Upon disposal of the taxpayer's entire interest in the activity, carryforward losses are allowed. If a taxpayer makes a gift of the entire interest in a passive activity, the donee's basis is increased by any carryforward losses of the donor. The rules were phased in during tax years between 1987 and 1991 for passive activities held on October 22, 1986. The rules apply in full to passive activities acquired after this date.

## **MATERIAL PARTICIPATION**

"Material participation" is defined as active involvement of the taxpayer or the taxpayer's spouse in the operations of an activity on a regular, continuous, and substantial basis. Taxpayers are likely to be materially participating in an activity if they do everything that is required to be done to conduct that activity, even though the actual amount of work to be done to conduct the activity is low in comparison to other activities. Other major factors in determining whether a person is materially participating are:

1. whether, and how regularly, the taxpayer is present at the place or places where the activity is conducted,
2. whether involvement in management is "merely formal and nominal", and
3. the knowledge or experience of the taxpayer with respect to the activity.

Taxpayers should be able to use consultants, employees, or contract services without making the activity passive if the consultants, etc. act under the direction of the taxpayer and not as a paid advisor directing the conduct of the taxpayer. However, the taxpayer must personally perform sufficient services to establish material participation.

Any work done in any capacity concerning an activity in which the taxpayer has an ownership interest counts as participation, except:

1. Work not customarily done by owners of such an activity and the principal purpose is to avoid passive loss rules; and
2. Work done by an individual as an "investor", unless the individual is directly involved in the day-to-day management and operations of an activity.

Work typically done by investors includes:

1. Studying and reviewing financial statements or reports on operations of an activity;
2. Preparing or compiling summaries or analyses of the finances or operations of an activity for your own use; and
3. Monitoring the finances or operations of an activity in a non-managerial capacity.

The extent of material participation may be established by any material means, such as daily time reports, diaries, appointment books, calendars, or narrative summaries. Any participation by your spouse is credited to your participation, whether or not you file a joint return. Thus, the total hours of participation by the husband and wife is used for the hours tests.

"Material participation" regarding the passive loss rule is different than "material participation" definitions for self-employment tax purposes or for special use valuation purposes. However, in the case of farming, an individual who is treated as having self-employment income with respect to the farm generally is considered to be materially participating for purposes of the passive loss rule.

Also, an individual is considered to “materially participate” during retirement or disability if the individual had materially participated for five or more of the eight years prior to the earlier of retirement or disability. Moreover, the material participation test is met by surviving spouses who inherit qualified real property from a deceased spouse if the surviving spouse engages in “active management”.

### **CASUALTIES AND THEFTS**

If your property is destroyed, damaged, or stolen, you may have a deductible loss. If the insurance or other reimbursement is more than the adjusted basis of the destroyed, damaged, or stolen property, you may have a taxable gain.

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. Events that may cause casualty damage include fire, flood, storm, lightning, and similar occurrences. Loss of property due to progressive deterioration is not deductible, because it does not result from a sudden event.

How you figure the deductible casualty loss depends on whether the loss was business or personal use property and whether the property was partly or completely destroyed. If your business property was completely destroyed or stolen, your casualty or theft loss is the adjusted basis of your property minus any salvage value and insurance or other reimbursement you receive or expect to receive. Do not consider any decrease in fair market value. If your business property was partially damaged, your loss is the smaller of your adjusted basis in the property before the casualty or the decrease in fair market value of the property as a result of the casualty. The smaller value is then reduced by the amount of insurance or other reimbursement that you receive or expect to receive. If the property is personal property, you must further reduce each casualty or theft loss by \$100. You must also reduce the total of all of your personal property losses by 10% of your adjusted gross income.

### **HOBBY LOSS RULES**

If an activity results in a profit in three out of five consecutive years, the Internal Revenue Service presumes the taxpayer is carrying out the activity with the intention of making a profit. If this test is not met, deduction of expenses requires proof based on demonstration of facts in your case that you intend to make a profit and that you have a reasonable expectation of making a profit.

Since most timber producers have to rely on demonstration of facts in their particular case, it is important that timber producers having a written management plan for their timber holdings that includes cash flow projections and an economic analysis.

### **LIMITS ON INVESTMENT INTEREST DEDUCTIONS**

The limit on investment interest deductions is the net investment income for the year. Unused interest deductions may be carried forward and applied to investment income in future years.

### **ITEMIZED DEDUCTIONS FOR TAXES**

The itemized deduction for state and local sales taxes was repealed effective January 1, 1987. The itemized deduction for state and local income taxes, real estate taxes and personal property taxes is retained.

Taxes that may not be deducted but which are incurred in a business or investment activity in connection with acquiring or disposing of property are not deductible, but may be treated as part of the cost of the acquired property or as a reduction in the amount realized at the time of disposition.

### **MISCELLANEOUS ITEMIZED DEDUCTIONS**

The deduction for miscellaneous itemized deductions is limited to the amount by which they exceed 2% of the adjusted gross income. This becomes important if the timber holdings are treated as an investment.

### **INVESTMENT TAX CREDIT**

The investment tax credit was repealed for property placed in service after December 31, 1985, except for qualified reforestation expenditures. Expenses that qualify are those for site preparation, seed or seedlings, labor, and small tools. The provisions are:

1. In the first year, a tax credit of 10% of reforestation expenses up to \$10,000 may be claimed.
2. Reforestation expenses may also be amortized over seven years, with 1/14 of the expenses deducted from income in the first year, 1/7 deducted in each of the next 6 years, and 1/14 deducted in year eight.

If the 10% credit is taken, then the amount which may be amortized is 95% of the reforestation costs.

However, if your timber activity is classified as a passive activity, these amounts can not be claimed until you have passive income against which you can claim them. Christmas tree operations have never qualified for this incentive.

### **DEPRECIATION**

The basics of the Accelerated Cost Recovery System (ACRS) are currently referred to as the

Modified Accelerated Cost Recovery System (MACRS). The provision for expensing the cost of eligible depreciable property continues as a section 179 deduction. The amount that can be expensed in 1998 is \$18,500. For every dollar of investment in depreciable property in excess of \$210,000 for the tax year, the \$18,500 allowable expense amount is reduced by one dollar. The amount eligible to be expensed is limited to the taxable income derived from an active trade or business. Finally, if property is converted to nonbusiness use at any time, the difference between the amount expensed and the ACRS or MACRS deductions that would have been allowed for the period of business use is recaptured as ordinary income.

## **TIMBER PRODUCTION CATEGORIES**

Timber production activities can be classified into the following five categories. Treatment of expenses varies for each category.

### **1. Hobby**

Timber production activities are carried out primarily for the pleasure of the taxpayer. Profit is not the primary motive. Only property taxes are deductible. Interest on funds borrowed to acquire or carry timberland are deductible only if the activity qualifies as an investment or a business.

### **2. Passive Investment**

Timber production activities are carried out with the primary objective of realizing a profit, but the taxpayer does not materially participate in the activity. Expenses are recovered as miscellaneous itemized deductions to the extent they exceed 2% of gross income and they are subject to passive loss rules.

### **3. Active Investment**

Timber production activities are carried out with the primary objective of realizing a profit and the taxpayer materially participates in the activity. Expenses are recovered as miscellaneous itemized deductions to the extent they exceed 2% of gross income.

### **4. Passive Trade or Business**

Timber production activities are extensive enough to constitute a trade or business, but the taxpayer does not materially participate in the business. Expenses are recovered on the appropriate business schedule, but are subject to the passive loss rules.

### **5. Active Trade or Business**

Timber production activities are extensive enough to constitute a business, and the taxpayer materially participates in the business. This category is unchanged. Expenses are recovered on the appropriate business schedule.

## **SUMMARY**

Many timber producers may find that it will be to their advantage to restructure their timber activities.

Investors who don't need the income may find it to their advantage to take advantage of the step-up in basis that occurs when assets pass through an estate. This essentially eliminates income tax on the unrealized gain from timberland during their lifetime. This assumes that heirs exist whom the investors want to benefit from their efforts.

Size and timing of timber sales is important to avoid large amounts of timber income occurring in the higher brackets. Also, timing of timber management expenses will be important to offset timber income. Timing will be especially important for hobby and passive activity ownerships to incur timber management expenses in the same year as timber income to obtain the maximum benefit of the expense deductions.

Many producers are going to need to keep better records of their activities and have in their files a written management plan of their activities that includes an economic analysis. It is these records that are used to factually determine whether the activity is held primarily for profit, whether the activity constitutes a business, and whether the taxpayer is materially participating. If at all possible, producers are going to want to fall into the "business" category, thus avoiding expenses deductible only in excess of 2% of gross income. It may be necessary for some producers to become more active to avoid the passive loss restrictions and/or raise the level of the timber production activities to that of a business.

## **ADDITIONAL INFORMATION**

Additional information may be obtained from the following internet address:

<http://www.irs.ustreas.gov/plain/cover.html>. Income tax treatment of timber management transactions is a complex subject. Landowners are advised to consult their tax preparer or attorney to determine specific interpretations of the regulations.